Michael J. Prell
May 20, 1997

FOMC BRIEFING

The Greenbook lays out what is, in many respects, a fairly attractive baseline scenario. Economic growth slows sharply from the first-quarter pace, but it remains strong enough to hold the unemployment rate below 5 percent. Although the underlying direction of inflation is up from here, the rise is gradual. Indeed, thanks to favorable developments in the food and energy sectors, and with a little help from technical changes to the index, headline CPI inflation only nudges the 3 percent mark next year.

To be sure, we're still saying that you'll probably need to raise interest rates further if you wish to keep inflation in check. But, according to our forecast, you could delay action for some time without fearing that events would seriously undermine what currently seems to be considerable public confidence that inflation will remain moderate well into the future.

On the other hand, we've also warned that, if our forecast is wrong, the greater risk is that aggregate demand will prove more buoyant and produce more troublesome inflationary pressures. There are two components to this assessment. The first relates to the prospects for aggregate demand itself, the second to how stronger demand might translate into greater inflation.

In the interest of conserving time, I won't dwell on the second issue. In a nutshell, we believe a tight labor market already has generated an upturn in compensation inflation--and that, were it not for the appreciation of the dollar, we would have seen a slight increase in core consumer inflation. With the dollar presumed to have topped out, that external influence is about to turn less favorable.

Within our analytical framework, one could paint a more sanguine inflation outlook by postulating some positive supply shocks. For example, the economy could be on the verge of the long-awaited productivity payoff from the investments in information technology. Or the dollar could resume its uptrend and continue to make it cheaper to tap foreign sources. But, we also could readily postulate unfavorable developments, such as crop shortfalls or disruptions of Middle Eastern oil supplies.

What I'd like to do is put aside for now this set of questions relating to the supply side of the equation and return to the matter of aggregate demand. In particular, I want to talk about the prospects for output growth and why we believe that the distribution of risks surrounding our baseline forecast continues to be skewed to the upside.

This is getting to be an excessively familiar refrain. We've been saying the same thing for a good many months now, and, frankly, I don't get a lot of gratification from getting only the errors right. So, in framing our latest projection, we certainly tried to assure ourselves that what we were writing down is the most likely outcome under the assumed monetary policy.

What we are forecasting is that growth of real GDP, which has been 4.1 percent over the past four quarters, will slow to 2.2 percent over the ensuing four. More than half of this deceleration is accounted for by a swing in inventory investment, which contributed heavily to output growth in the year ended in the first quarter, and is projected to retard growth appreciably in the coming year. The remainder of the slowing is attributable to various components of final sales, none of which individually makes an especially remarkable contribution.

Now, given the dynamics of the economy, one can't look at inventories and final demand separately in assessing the plausibility of the forecast. As we indicated in the Greenbook, it would seem unreasonable to expect that firms will continue indefinitely to accumulate stocks at the 5 percent annual rate of the first quarter. But, if final demand were to fail to decelerate as we've forecast, then inventory investment certainly could run close to that pace for a year without pushing stock-sales ratios to burdensome levels. Indeed, such strong demand growth could well lead to circumstances in which supply channels were strained and firms raised their target inventory ratios to insure against stock-outs--if not as a hedge against rising costs.

So, it all would seem to come down to whether it is reasonable to forecast, as we have, that final sales will grow 2-1/2 percent over the coming year, instead of 3-1/4 percent as in the last. There are a number of elements of the economic and financial picture that lead us to think that demand will slow to this moderate degree. One is that we have seen hefty growth in real outlays for consumer and producers' durables in the past few years, and the levels of investment already are sufficient to allow stocks to grow at a good clip. Similarly, in the housing market, building is widely viewed as having run for a while now at a pace somewhat above what one might expect to be sustained, given demographic trends. Nominal interest rates, which had dropped during 1995, generally rose from late 1995 to early 1997--and real rates probably rose still more, judging by surveys of inflation expectations, especially longer-term expectations. And the dollar rose considerably over the past year, which should weigh on net exports in coming quarters.

We think these are, cumulatively, reasonably persuasive arguments for expecting growth of final demand to slow. Of course, one might have told some of these same stories prior to the surge of the past couple of quarters. In fact, we did! But, in the interim, the stocks of real assets have only grown larger, and much of the dollar's run-up has occurred just since last fall.

What gives us pause, however, and causes us to continue emphasizing the upside risks to aggregate demand, is some of the other developments that have occurred in the interim. Business sentiment appears to have improved. And indexes of consumer sentiment have skyrocketed--to an unprecedented level in the case of last Friday's preliminary Michigan SRC survey for May. Perhaps reflecting those moods, or contributing to them, the stock market has soared to new heights, adding to household wealth and lowering the cost of equity capital for corporations; indeed, last week, we saw some hints that the IPO market, which has been in a lull, might be starting to revive. Banks, though becoming more chary of lending to marginal consumers, have become still more aggressive in seeking business loans. The commercial real estate market is showing ever more signs of booming.

A number of these factors are in the nature of "animal spirits." Their force is hard to gauge, and they could also prove fragile and ephemeral. But they are there now, and we would be more concerned that we haven't made adequate allowance for them in our baseline forecast than that we've overestimated their significance. We certainly see the risk of their imparting some extra cyclical momentum to demand as greater than the probability that the economy will go flat in the near term. And, if that upside risk were to materialize, it likely would take a pretty sharp policy move to avoid a significant deterioration of the inflation outlook.

Contributions to Real GDP Growth
(Percentage Points)

	1996:Q1–1997:Q1	1997:Q1–1998:Q1	Deceleration
GDP	4.1	2.2	1.9
Inventory investment	.8	–.3	1.1
Final Sales	3.3	2.5	.8
PCE	2.2	1.9	.3
BFI	1.1	1.0	.1
Residential investment	.1	0	.1
Government	.3	.2	1
Net exports	–.4	–.5	.1

NOTE: Based on staff estimates of 1997:Q1 GDP. Contributions do not sum precisely to the totals owing to rounding and residuals.